

ANNUAL REPORT
OF THE
PENSION MANAGEMENT OVERSIGHT COMMISSION



Indiana Legislative Services Agency
200 W. Washington Street, Suite 301
Indianapolis, Indiana 46204

November, 2011

INDIANA LEGISLATIVE COUNCIL

2011

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PENSION MANAGEMENT OVERSIGHT COMMISSION

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Peggy Piety
Attorney for the Commission

Allen Morford
Attorney for the Commission

Camille Tesch
Fiscal Analyst for the Commission

Chuck Mayfield
Fiscal Analyst for the Commission

I. STATUTORY AND LEGISLATIVE COUNCIL DIRECTIVES

The Indiana General Assembly enacted legislation (IC 2-5-12) directing the Pension Management Oversight Commission (Commission) to do the following:

- (1) Study the investment and management practices of the boards of the public retirement funds.
- (2) Determine what constitutes adequate wage replacement levels at retirement (including benefits from public retirement funds and Social Security) for public employees.
- (3) Study the impact of federal law and proposals concerning pensions, annuities, and retirement benefits.
- (4) Study the retirement funds established in IC 36-8.
- (5) Study methods and levels of funding for public retirement funds.
- (6) Study other topics as assigned by the Legislative Council.
- (7) Study other topics as directed by the Commission's chair.

The Commission consists of 12 members: four Representatives, four Senators, and four lay members who must be experts in the areas of finance, investments, or pension fund management. The chair of the Legislative Council appoints the chair of the Commission.

The Legislative Council also assigned the Commission the additional responsibility of studying the issue of whether the surviving spouse of a judge should receive a cost of living adjustment (COLA) or other type of benefit increase as part of the spouse's survivor benefits.

II. INTRODUCTION AND REASONS FOR STUDY

This year the Commission reviewed the following:

- (1) Whether the minimum benefit for the surviving spouse of a member of the Judges' Retirement System should be increased or whether the spouse should receive an annual COLA.
- (2) The difference in administering a defined contribution (DC) plan and a defined benefit (DB) plan.
- (3) A request by the Indiana Public Retirement System (INPRS) to disclose certain member records of a member of the Public Employees' Retirement Fund (PERF) or the Indiana State Teachers' Retirement Fund (TRF) to an individual providing personnel administrative services for the member's employer.

III. SUMMARY OF WORK PROGRAM

The Commission met three times on the following dates:

August 3, 2011
September 28, 2011
October 25, 2011

All three of the meetings were held in the State House in Indianapolis.

IV. SUMMARY OF TESTIMONY

A more detailed summary of the testimony may be found in the meeting minutes.

A. INPRS Annual Report

Steve Russo, INPRS Executive Director, presented INPRS's 2011 report to the Commission.

Overview

Mr. Russo reported that INPRS currently serves more than 480,000 members. The member/employer contributions paid in FY 2011 totaled \$1.9 B and benefits to retirees and beneficiaries amounted to \$3.9 B. As of June 30, 2011, INPRS had net assets worth \$25.7 B. Five percent of the state's revenue is currently used to support public pensions. The aggregate funded ratio of the pre-funded plans currently administered by INPRS is 93.4%. INPRS expects the aggregate funding ratio to drift lower through FY 2013 because of smoothing requirements for investment gains or losses.

Mr. Russo also discussed the state's funding plan for the TRF's pre-1996 account. The pre-1996 account has a \$10.9 B liability. Currently, the Pension Stabilization Fund (PSF) has approximately \$2 B. The PSF will decline slowly until FY 2028. INPRS predicts that benefit payments from the TRF pre-1996 fund will peak in approximately 2025 and will slowly decline thereafter.

Investment Performance

Mr. Russo summarized INPRS's investment performance. The rate of return of all asset classes was positive and has exceeded the respective benchmarks.

Asset Allocation

INPRS is currently working to consolidate the asset allocations of the various plans. A new allocation plan is expected by the end of 2011. Implementation of the plan should take approximately 12 to 24 months.

Operational Performance

Mr. Russo discussed the operational performance of INPRS. INPRS has been recognized in customer service and administrative efficiency by a global pension system benchmarking firm. It has also received certificates of achievement for excellence in financial reporting from the Government Finance Officers Association and has received public pension standards awards for funding and administration from the Public Pensions Coordinating Council.

PERF/TRF Consolidation Update

Mr. Russo provided an update on the consolidation of PERF and TRF. INPRS calculates administrative cost savings from the consolidation at \$1.5 M per year. Current investment consolidation savings are \$10.6 M per year and additional investment cost savings will occur as a combined asset allocation is implemented.

Use of Placement Agents

Mr. Russo also discussed the use of placement agents. INPRS contractually prohibits the payment of placement agent fees by the investment manager or any affiliate in connection with an INPRS investment without the investment manager disclosing the payment of those fees. INPRS board members and staff are governed by an Indiana code of ethics that prohibit the receipt of compensation or gifts from those who do business or are seeking business from the fund.

The INPRS board of trustees has delegated most of the investment manager selection to staff members. Also, investment manager recommendations are independently vetted by a consultant hired by the INPRS board of trustees. INPRS investment staff sign an affidavit of compliance form for each recommended investment and now file annual financial disclosure statements with the state ethics commission.

Governmental Accounting Standards Board (GASB) Rule Changes

Mr. Russo summarized proposed GASB rule changes to bring consistency to various public retirement fund reporting requirements. The new GASB rules mandate a five year smoothing on investment gains and losses whereas INPRS currently uses a four year smoothing on investments. Also, the proposed GASB rules will also require local units of government to report their share of a cost-sharing plan's net pension liability.

Actuarial Assumptions

Mr. Russo described the actuarial assumptions used by INPRS. He stated that the investment rate or return assumption and the asset valuation method are two of the most influential actuarial assumptions used by INPRS. He then stated that INPRS uses an investment rate or return assumption of seven percent. The inflation assumption is a major component of assumed wage

growth. The spread between investment rate of return and wage growth is a key driver of active participant costs.

COLAs

Mr. Russo discussed cost of living adjustments (COLAs) for the various funds administered by INPRS. With the exception of the Judges' Retirement System and the 1977 Police Officers' and Firefighters' Pension and Disability Fund (1977 Fund), COLAs are ad-hoc. Actuaries calculate ad-hoc COLAs based upon historical experience. With the exception of the TRF pre-1996 account, COLAs are funded by the employer as part of their contribution rate.

B. DB Plans and DC Plans

Al Gossard, Deputy Director, Office of Fiscal and Management Analysis, Legislative Services Agency, summarized four differences between a DB plan and a DC plan: (1) vesting requirements; (2) cost-of-living adjustments (COLA); (3) risk and predictability; and (4) adverse selection.

Cindy Fraterrigo of Price Waterhouse Coopers, actuary for PERF, and John Dowell of the Nyhart Company, actuary for TRF, provided a presentation examining a hypothetical scenario which allows INPRS members the option to voluntarily convert their DB benefits to a DC plan. After describing the assumptions used in the scenario, Ms. Fraterrigo made several observations regarding a voluntary conversion from a DB plan to a DC plan. Ms. Fratterrigo then described the following advantages and disadvantages to employers under the scenario:

- (1) Improved cost stability because there is no unfunded liability or cost volatility for DC members.
- (2) The employer no longer bears the risk of investment returns, longevity of members, and inflation or salary increases for members electing the DC plan.
- (3) Since members will need to be educated about DB or DC choices, it will create a better understanding of employee's retirement benefits.
- (4) If members choose the most economic benefit for themselves, there will be increased cost to employers with the remaining DB plan participants.
- (5) There will be less flexibility for managing the workforce.

Ms. Fratterrigo then provided testimony regarding additional considerations when determining whether to offer employees the option to transfer from a DB to a DC plan:

- (1) DB benefits generally offer spousal survivor benefits and it may be beneficial to require spousal consent to transfer to a DC plan.
- (2) Providing disability or death protection for DC members.
- (3) Allowing loans from the DC plan and the potential impact on retirement savings.

- (4) The economic and societal impacts of moving to only DC plans are still unknown. For example, what happens if a retiree uses up their DC retirement benefits.

Doug Todd of McCready and Keene provided a general comparison of DB and DC plans. He briefly described the following issues that an employer should keep in mind when comparing a DB plan and a DC plan:

- (1) Investment risk.
- (2) How benefits accrue.
- (3) Portability.
- (4) Design issues.
- (5) Death and disability.
- (6) Flexibility.

Tom Hanify, President of the Professional Firefighters Union of Indiana, and Tim Downs, President of the Fraternal Order of Police, discussed the effects on public safety pensions if members were required to convert from a DB plan to a DC plan.

Mr. Hanify testified that the 1977 Police Officers' and Firefighters' Pension and Disability Fund (1977 Fund), in addition to providing retirement benefits, provides disability benefits to eligible members and death benefits for surviving spouses and children.

Mr. Hanify provided testimony that the 1977 Fund is a well governed pension. He also provided three examples to show how a firefighter or police officer's benefit will be reduced if the firefighter or police officer converted their DB benefits to a DC plan.

Mr. Downs provided a brief history of public safety pensions in Indiana and described how the early public safety pensions developed into the current 1977 Fund.

Chief Ken Gilliam, President of the Indiana Association of Fire Chiefs, and Chief Konzen of the Wayne Township Fire Department in Marion County discussed the cost of recruiting qualified applicants and the mental and physical stress associated with public safety jobs. They testified that the 1977 Fund helps with recruitment.

Bryan Shearer, representing the Indiana Association of Chiefs of Police, testified that the 1977 Fund is a valuable tool in the recruitment and retention of new employees.

Tom Miller of the International Association of Firefighters testified that the 1977 Fund well managed and is envied across the country.

Phil Troyer of NRP Financial Inc. and NRP Advisors, Inc. provided testimony in favor of converting DB plans to DC plans. Mr. Troyer explained that the number of private DB pension plans is declining because of longevity risk, investment risk, and cost. Mr. Troyer then stated

that a DC plan benefits taxpayers by transferring the longevity risk, investment risk, and cost to the employee.

Nancy Pappas, representing the Indiana State Teachers' Association, testified against converting DB plans to DC plans.

Emma Hawkins, representing the Indiana State Employees' Association, testified that she was concerned that the elimination of the DB plan would eliminate the 13th check.

Andy Thomas, representing the Indiana Retired Teachers' Association, questioned whether an optional transfer to a DC plan would save any money or solve any existing problem. He also expressed concern about shifting risk to employees.

C. Status Report on SEA 501-2007 (P.L. 44-2007)

Mr. Jon Vanator, Deputy Director, State Budget Agency provided a status report on SEA 501-2007 which is a retirement medical benefits account for members of the General Assembly, state elected officers, and employees of the executive, legislative, and judicial branches of government. The retirement medical benefits account was established as a health reimbursement arrangement. The account is funded with: (1) annual contributions received from the state on behalf of an active participant; (2) if applicable, a "bonus contribution" from the state; and (3) investment earnings.

Mr. Vanator testified that the State Budget Agency participates at personnel pre-retirement seminars and has provided correspondence to over 30,000 employees and maintains a website which contains information regarding the retirement medical benefits accounts.

Mr. Vanator testified that 5.74% of cigarette tax revenues, totaling \$27 M in FY 11, was deposited directly into the Retiree Health Trust Fund. Also, in FY 11, the total cost of the account equals \$50.6 M and the total claims paid equaled \$9.6 M. The administrative cost totaled \$278,917.

Mr. Vanator summarized recent statutory changes made to the retirement medical benefits account. The changes include actuarial funding for active participants and a two year deferral of cigarette tax revenue. Also, members of the Indiana State Police and members of the State Excise Police, Gaming Agent, Gaming Control Officer, and Conservation Officers' Retirement Fund (C & E Fund) were removed from the plan because these individuals have similar plans available to them.

D. Update on Internal Revenue Code (I.R.C) Section 401(h) Public Employees' Retirement Fund

Allison Murphy, Legislative Director, INPRS, provided an update on INPRS's implementation of its I.R.C. 401(h) account for state employees. SEA 501-2007 requires state employees who retire from state employment to convert the balance of their unused vacation leave into an account

managed by INPRS. Mrs. Murphy testified that INPRS is currently waiting for approval of the 401(h) account from the Internal Revenue Service. INPRS is currently preparing an implementation plan.

E. Divestment from States that Sponsor Terrorism and Sudan

Mr. Russo summarized the requirements of HEA 1067-2007, which prohibits INPRS from acquiring or owning securities of certain companies that have active business operations in Sudan.

As of February 11, 2011, INPRS had exposure to five companies on the Sudan Restricted List. As of June 30, 2011, INPRS reduced its exposure to two companies. INPRS will continue to divest the remaining shares of the two companies over the next eight months of the current divestment period. Mr. Russo testified that INPRS has been and continues to be in full compliance with the Sudan divestment legislation.

Mr. Russo summarized HEA 1547-2009, which prohibits INPRS from acquiring or owning securities of certain companies that have active business operations in a state that sponsors terror.

As of February 11, 2011, INPRS had exposure to 16 companies on the Terror States Restricted List. On June 30, 2011, INPRS reduced its exposure to eight companies on the list. Mr. Russo explained the INPRS will continue to divest from the terror state scrutinized companies within the guidelines provided in the legislation.

F. INPRS Issues

Disclosure of a PERF or TRF Member's Records

Allison Murphy stated that employers regularly request the ability to access member accounts in order to provide their employees with retirement counseling services. She indicated that confidentiality laws currently prohibit INPRS from providing the employer access to any specific member account information.

INPRS Administration

The Commission discussed Preliminary Draft (PD) 3257, which repeals a requirement that certain retirement plans of the state or a political subdivision must report to PERF information necessary for the PERF actuary to perform an actuarial valuation of the plan. It also requires that INPRS pay the direct and indirect costs of the State Board of Accounts' examination of the public pension and retirement funds administered by the system.

Steve Russo testified that INPRS is not currently collecting the information from plans not administered by INPRS and is unable to perform actuarial valuations of those plans because the exclusive benefit restriction prevents INPRS from using its funds to perform actuarial

evaluations of funds that it does not administer.

After discussing the contents of PD 3257, the Commission members decided not to take action on the PD.

G. Pending Federal Legislation (H.R. 567/S. 347)

Peggy Piety, attorney for the Commission, provided a summary of federal public employee pension transparency legislation currently introduced in Congress. She explained that there are two identical bills (H.R. 567 and S. 347) in Congress that address public employee pension transparency.

Ms. Piety explained that the bills deny federal tax benefits relating to bonds issued by the state or political subdivision if the state or political subdivision fails to meet certain annual reporting requirements. She described the reporting requirements contained in the bills.

H. Indiana Law concerning Public Pension Plan Amendments

Ms. Piety provided a general overview of Indiana law concerning amendments made to public pension plans. Ms. Piety discussed factors used to determine the difference between mandatory public employee plans and voluntary public employee plans.

Mrs. Piety summarized the following Indiana case law:

-Haverstock v. State Public Employees Retirement Fund, 490 N.E. 2d 357 (Ind. Ct. of App., 1st Dist. 1986)

-Bd. of Trustees v. Hill, 472 N.E.2d 204 (Ind. 1985)

Ms. Piety discussed a state's ability to modify public pensions using its police power. In her discussion she relied on *U.S. Trust v. New Jersey*, 431 U.S. 1 (1977), which provides in part that a state has the ability to use its police power to modify contracts where the police power is reasonable and necessary to achieve an important public purpose.

I. Thirteenth Checks

Representative Burton testified that he will be filing a bill providing a 13th check to retirees.

Steve Barley testified that INPRS is currently in the process of determining the cost associated with a COLA. He stated that a 13th check for members of the TRF Pre-1996 Fund would affect the General Fund and the Pension Stabilization Fund.

V. COMMITTEE FINDINGS AND RECOMMENDATIONS

The Commission made the following recommendations:

The Commission voted with a vote of eight to one to recommend PD 3097, as amended, for introduction in the 2012 session of the General Assembly. PD 3097, as amended, increases the minimum retirement annuity for a surviving spouse or surviving child of a participant of the 1977 Judges' Retirement System or the 1985 Judges' Retirement System (jointly referred to as the Judges' Retirement System) from \$12,000 to \$17,000.

The Commission voted unanimously to recommend PD 3113, as amended, for introduction in the 2012 session of the General Assembly. PD 3113, as amended, provides that INPRS may disclose member financial records of a member PERF or TRF to the member's public employer or the designated representative of the employer if they maintain confidentiality of the information and only use the information to provide retirement counseling.

PD 3236 was unanimously recommended for introduction in the 2012 session of the General Assembly. PD 3236 makes required technical corrections and conforming amendments following the enactment of SEA 524-2011 and SEA 549-2011.

The Commission voted unanimously by consent to accept the draft copy of the final report with the understanding that action taken at the Commission's last meeting on October 25th would be included in the final report.

WITNESS LIST

Steve Barley, Indiana Public Retirement System
Tim Downs, Fraternal Order of Police
John Dowell, Nyhart Company
Cindy Fraterrigo, Price Waterhouse Coopers
Chief Ken Gillium, Indiana Association of Fire Chiefs
Al Gossard, Legislative Services Agency
Tom Hanify, Professional Firefighters' Union of Indiana
Emma Hawkins, Indiana State Employees' Association
Chief Gene Konzen, Wayne Township Fire Department
Tom Miller, International Association of Firefighters
Allison Murphy, Indiana Public Retirement System
Nancy Pappas, Indiana State Teachers' Association
Peggy Piety, Legislative Services Agency
Steve Russo, Indiana Public Retirement System
Bryan Shearer, Indiana Association of Chiefs of Police
Andy Thomas, Indiana Retired Teachers' Association
Doug Todd, McCready and Keene
Phil Troyer, NRP Financial Inc.
John Vanator, State Budget Agency